

## Message Text

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ACTION EUR-12

INFO OCT-01 EA-09 ISO-00 AID-05 CIAE-00 COME-00 EB-07  
FRB-01 INR-07 NSAE-00 USIA-15 XMB-04 OPIC-06  
SP-02 LAB-04 EPG-02 SIL-01 OMB-01 NSC-05 SS-15  
STR-04 CEA-01 L-03 H-02 PRS-01 PA-02 AGRE-00  
/110 W

-----025930 211240Z /46

R 211201Z JUN 77  
FM AMEMBASSY LONDON  
TO SECSTATE WASHDC 5310  
TREASURY DEPT WASHDC  
INFO AMEMBASSY BONN  
AMEMBASSY BRUSSELS  
AMEMBASSY PARIS  
AMEMBASSY ROME  
AMEMBASSY TOKYO

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USEEC ALSO FOR EMBASSY  
USOECD ALSO FOR EMBASSY

DEPARTMENT PASS FEDERAL RESERVE BOARD

E.O. 11652: N/A  
TAGS: EFIN, UK  
SUBJECT: BANK OF ENGLAND QUARTERLY BULLETIN

SUMMARY: THE BANK OF ENGLAND'S LATEST QUARTERLY BULLETIN PRESENTS A POLICY ASSESSMENT LOOKING BEYOND THE IMMEDIATE ECONOMIC SITUATION WHICH IS CHARACTERIZED AS "RELATIVELY UNEVENTFUL". THE IMPORTANCE OF PROFITS AND THE ROLE OF MONETARY TARGETS ARE THE PRINCIPAL AREAS OF DISCUSSION.  
END SUMMARY.

1. PROFITS. NOTING THAT THE REAL RATE OF RETURN ON COR-  
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PORATE ASSETS HAS FALLEN BELOW THE REAL COST OF CAPITAL EACH YEAR SINCE 1973, THE BANK STRESSES NEED FOR IMPROVEMENT IN THE PROFITABILITY OF U.K. INDUSTRY. CONTINUING A PATTERN BEGUN IN THE LATE 1960'S, THE REAL RATE OF RETURN REACHED A LEVEL IN 1975 AND 1976 JUST ONE-THIRD THAT PREVAILING IN 1965. PART OF THIS IS ATTRIBUTED TO CYCLICAL FACTORS. HOWEVER, THESE HAVE BEEN LONG-LIVED AND MAY

WELL MEAN THAT FULL RECOVERY WILL BE DIFFICULT FOR THE U.K. IF IT MUST RELY SOLELY ON ITS OWN RESOURCES. THUS, THE BANK MENTIONS THE IMPORTANCE OF RECOVERY IN OTHER COUNTRIES AS A MEANS OF PROVIDING ADDED IMPETUS. ACCORDING TO THE BANK' SUCH ASSISTANCE MAY NOT BE AS GREAT AS MIGHT BE HOPED SINCE OTHER COUNTRIES ALSO FACE THE NEED TO REIN IN INFLATION. A SLOW UPTURN WILL EF- FECT THE RECOVERY OF U.K. PROITABILITY. HOWEVER, IN THE ABSENCE OF SUCH A RECOVERY, BRITAIN'S LONGER TERM PROSPECTS COULD BE SERIOUSLY DAMAGED AS INVESTMENT IS LIKELY TO FALL SHORT OF THE LEVEL NEEDED TO SUSTAIN GROWTH. THE BANK ADDS THAT WHILE PROFITS BEGAN TO RECOV- ER IN 1976, PART OF THE IMPROVEMENT WAS ATTRIBUTABLE TO RAPIDLY INCREASING NORTH SEA OIL OUTPUT WHOSE EFMFTT IS LIMITED TO RELATIVELY FEW FIRMS. FOR THE BULK OF U.K. COMPANIES' THE RECOVERY IN PROFITS WAS LESS PRONOUNCED.

2. MONETARY TARGETS. THE BANK DEVOTES CONSIDERABLE SPACE TO A DISCUSSION OF MONETARY TARGETS. INTRODUCED IN THE U.K. FOR THE FIRST TIME IN 1976. IT STATES THAT "PRIOR ANNOUNCEMENT OF TARGETS MAY REINFORCE THE PURPOSE- IVENESS OF MONETARY POLICY AND PROVIDE ASSURANCE THAT THE AUTHORITIES WILL NOT JUST ACCOMMODATE TO PRESSURES WHICH MAY ARISE." IT IS STRESSED THAT IN TIMES WHEN THE BALANCE OF PAYMENTS IS STRENGTHENING, M3 RATHER THAN DO- MESTIC CREDIT EXPANSION TARGETS SHOULD RECEIVE GREATER UNCLASSIFIED

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EMPHASIS BECAUSE OF THE ADDITION TO GROWTH OF M3 RESULT- ING FROM A BALANCE OF PAYMENTS SURPLUS. THE RADICAL CHANGE IN FINANCIAL CLIMATE OVER THE LAST YEAR IS ATTRIB- BUTED TO A SHARP CHANGE IN THE RATE OF MONETARY EXPAN- SION. THESE WERE DUE IN PART TO THE CHANGING STATE OF BUSINESS CONFIDENCE IN THE GOVERNMENT'S ECONOMIC POLICY.

THE BANK REPLIED TO CRITICS WHO EXPRESSED CONCERN OVER THE FALL IN THE MONETARY AGGREGATES DURING THE LAST SIX MONTHS. IT FIRST EMPHASIZED THAT ALTHOUGH THE BANK MAY HAVE MONETARY TARGETS, IT DOES NOT CONTROL THE MONE- TARY AGGREGATES DIRECTLY. BUT RATHER INDIRECTLY, THROUGH. FOR EXAMPLE, THE SALE OF GILTS. LAGS IN COLLECTING AND COMPILING DATA MEANTHAT GILT SALES ARE IN FACT CARRIED OUT WITHOUT HAVING PRECISE KNOWLEDGE (ALBEIT WITH CARE- FUL ESTIMATES) OF THE ACTUAL LEVEL OF THE PUBLIC SECTOR BORROWING REQUIREMENT AND THE LEVEL OF THE MONETARY AG- GREGATES AT THE MOMENT OF SALE. THE BANK, A FORTIORI, MUST WAIT TO SEE IF ANY DEVIATION FROM ITS TARGET IN FACT INDICATES A DEVIATING TREND.

THE BANK, IN A SECOND POINT, REPLIED THAT THE EFFECT OF CHANGES IN THE MONEY STOCK ON LEVELS OF OUTPUT, EM-

PLOYMENT AND INFLATION IS FELT ONLY OVER TIME. LONG LAGS,  
SUCH AS THOSE FOR STOCKBUILDING AND FIXED INVESTMENT  
WHICH MAY EXCEED TWO YEARS, DAMPEN SHARP SHORT-TERM MONE-  
TARY MOVEMENTS.

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3. TO REDUCE THE DIFFICULTY OF JUDGING THE STATE OF CUR-  
RENT FINANCIAL CONDITIONS, THE BANK OF ENGLAND IS CURRENT-  
LY CONSIDERING THE FEASIBILITY OF COLLECTING WEEKLY MONE-  
TARY DATA. THE BANK'S ABILITY TO CARRY OUT MONETARY POLI-  
CY SMOOTHLY UNDER A VARIETY OF CONDITIONS HAS FURTHERMORE  
BEEN ENHANCED BY THE INTRODUCTION OF VARIABLE INTEREST  
BONDS AND BONDS WHOSE PAYMENTS ARE STAGGERED OVER MANY  
WEEKS.

4. THE BANK COMPLETES ITS ASSESSMENT BY NOTING THAT THE  
CURRENT M3 TARGET, 9 TO 13 PERCENT, IMPLIES THAT FOR REAL  
GROWTH TO BE ACCOMMODATED, THE RISE IN WAGE COSTS "WILL  
NEED TO BE SIGNIFICANTLY BELOW THIS..." IT ADDS THAT THE

RECENT DECLINE IN INTEREST RATES PROBABLY REFLECTED EX-  
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PECTATIONS OF LOWER PRICE INFLATION. INTEREST RATES  
COULD RISE IF THIS IMPROVEMENT FAILS TO OCCUR. IT CON-  
CLUDES "A MONETARY POLICY GEARED TO A PUBLIC MONETARY TAR-  
GET IS A SEMI-AUTOMATIC WAY OF HELPING TO ACHIEVE SUCH AN  
AIM (RESISTING INFLATION). IT MAY NOT BE COMPLETELY SUF-  
FICIENT. BUT IT WILL WORK IN THE RIGHT DIRECTION. IT  
DOES NOT RULE OUT DISCRETIONARY DEMAND MANAGEMENT, BUT IT  
WILL HELP TO MAKE IT LESS NECESSARY."

5. COMMENT: THE BANK'S REPLY TO ITS CRITICS HAS ELICIT-  
ED RESPONSES. THE LATEST MONTHLY BULLETIN OF THE PROMI-  
NENT STOCKBROKER, W. GREENWELL AND CO., QUESTIONS WHETHER  
A SIX-MONTH DECLINE COULD BE REGARDED AS A SHORT-TERM  
VARIATION. THE BULLETIN NOTES IN PARTICULAR THAT THE AN-  
NUALIZED DECLINES (A) IN REAL M1 OF 17 PERCENT OVER THE  
LAST SIX MONTHS AND 8 PERCENT OVER THE LAST YEAR, AND  
(B) IN REAL TOTAL M3 OF 18 PERCENT OVER THE LAST SIX  
MONTHS AND 8 PERCENT OVER THE YEAR, APPEAR TO BE AMONG  
THE MORE SEVERE DECLINES OF THE PAST TWENTY YEARS. GREEN-  
WELL'S DOES NOT GIVE THE BANK'S REFERENCES TO "FINANCIAL  
READJUSTMENTS" AS THE CAUSE OF THE CONTRACTION A GREAT  
DEAL OF WEIGHT, AND CONTINUES TO FORECAST A RECESSION.

6. WHILE THIS DEBATE IS FAR FROM SETTLED, IT IS CLEAR  
THAT THE BANK'S ELUCIDATION OF THE ROLE OF MONETARY TAR-  
GETS HAS MOVED THE FOCUS OF DISCUSSION A CONSIDERABLE  
DISTANCE TOWARD THE MONETARIST CAMP. IT REPRESENTS AN-  
OTHER STEP AWAY FROM THE TRADITIONAL HMTREASURY AND BANK  
OF ENGLAND METHOD OF ECONOMIC POLICY MANAGEMENT WHICH UN-  
TIL LAST YEAR HAD FOCUSED, SOMETIMES VIRTUALLY EXCLUSIVE-  
LY, ON THE BEHAVIOR OF REAL RATHER THAN FINANCIAL AGGRE-  
GATES.

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## Message Attributes

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